



## Testimony

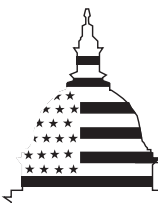
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# WELFARE REFORM

## Challenges in Saving for a “Rainy Day”

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**Abstract**

Mr. Chairman and Members of the Subcommittee: Thank you for inviting me here today to discuss states plans for operating their welfare programs in the event of an economic downturn. In the block grant environment, the federal government has an interest in encouraging states to save for future contingencies, but within a framework that recognizes that the size of the reserve will remain largely a state determination made under conditions of inherent uncertainty. In 1998 we reported on states plans for financing their welfare programs in the event that the economy unexpectedly turned down. 1 At that time most states budget forecasts predicted that the robust economy would continue providing strong revenue growth potential and, more important for states Temporary Assistance for Needy Families (TANF) budgets, diminishing costs in many social services programs. Last year, this subcommittee asked us to revisit the states examined in our 1998 report and to, among other things, look anew at their contingency plans. In part, my statement today includes research we conducted in 10 states (California, Colorado, Connecticut, Louisiana, Maryland, Michigan, New York, Oregon, Texas, and Wisconsin). As we will discuss more fully later in this testimony, the data available on the levels and adequacy of states reserves is insufficient and misleading. Furthermore, our case studies suggest that most states have done little planning for economic contingencies. Because states new welfare programs remain untested in times of downturn, these uncertainties make it difficult for anyone to predict how states will respond and how former welfare recipients will be affected if and when economic conditions change. Despite the significant changes made to the nations welfare program, the economy will no doubt play a role in determining how many people return to the welfare rolls and how long they, and those currently on the rolls, will remain if there are fewer job opportunities available. As economic forecasts have begun to change, there is some concern that the states might not be as prepared as they could be to manage the new fiscal challenges under welfare reform. Many adults

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Thank you for inviting me here today to discuss states' plans for operating their welfare programs in the event of an economic downturn. In the block grant environment, the federal government has an interest in encouraging states to save for future contingencies, but within a framework that recognizes that the size of the reserve will remain largely a state determination made under conditions of inherent uncertainty. In 1998 we reported on states' plans for financing their welfare programs in the event that the economy unexpectedly turned down.<sup>1</sup> At that time most states' budget forecasts predicted that the robust economy would continue providing strong revenue growth potential and, more important for states' Temporary Assistance for Needy Families (TANF) budgets, diminishing costs in many social services programs. Last year, this subcommittee asked us to revisit the states examined in our 1998 report and to, among other things, look anew at their contingency plans. In part, my statement today includes research we conducted in 10 states (California, Colorado, Connecticut, Louisiana, Maryland, Michigan, New York, Oregon, Texas, and Wisconsin).

As we will discuss more fully later in this testimony, the data available on the levels and adequacy of states' reserves is insufficient and misleading. Furthermore, our case studies suggest that most states have done little planning for economic contingencies. Because states' new welfare programs remain untested in times of downturn, these uncertainties make it difficult for anyone to predict how states will respond and how former welfare recipients will be affected if and when economic conditions change. Despite the significant changes made to the nation's welfare program, the economy will no doubt play a role in determining how many people return to the welfare rolls and how long they, and those currently on the rolls, will remain if there are fewer job opportunities available.

As economic forecasts have begun to change, there is some concern that the states might not be as prepared as they could be to manage the new fiscal challenges under welfare reform. Many adults have left the rolls for work since TANF was implemented—caseloads have dropped more than 50 percent nationwide—and those remaining on the rolls have increased their work efforts. Greater emphases on work implies a tighter link to

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<sup>1</sup> *Welfare Reform: Early Fiscal Effects of the TANF Block Grant* ([GAO/AIMD-98-137](#), August 22, 1998).

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work and hence the economy. This could make TANF more sensitive to an economic downturn than Aid to Families with Dependent Children (AFDC) if former recipients return to the rolls when they are laid off, causing state TANF budgets to rise. However, the flexibility of the grant combined with significant unspent TANF balances may help mitigate the fiscal fallout from economic downturns.

In today's testimony I plan to address three points:

- The shifting fiscal balance between the states and the federal government and the challenges this new partnership poses in financing and strengthening the safety net during times of economic stress.
- The potential for states to draw on their TANF grants and state reserves to cushion fiscal and economic shocks to the program.
- The complexity in the design of existing TANF contingency mechanisms that limits the effectiveness of these mechanisms in responding to uncertainties in the economy.

Finally, I would like to conclude with some options this Subcommittee might consider that could lead to refinements in the new fiscal partnership on welfare, giving the states more incentives to save while maintaining the federal role in the safety net.

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## New Fiscal Partnership Poses Challenges

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. No. 104-193) (PRWORA) made sweeping changes to national welfare policy. Principally, these reforms gave states the flexibility to design their own programs and the strategies necessary for achieving program goals, including how to move welfare recipients into the workforce. But because the act also changed the way in which federal funds for welfare programs flow to the states, most of the program's fiscal risks also shifted to the states. PRWORA created the TANF block grant, a fixed federal funding stream that replaced the AFDC and related programs in which federal funding matched state spending and increased automatically with caseload. Under AFDC, which entitled eligible families to aid, the federal funding was largely open-ended so that if a state experienced caseload and related cost increases, federal funds would increase with state funds to cover expenditures for the entire caseload. This open-ended federal commitment provided that financing for every dollar spent on these programs was shared by the federal government and the states, thereby limiting the states' exposure to escalating costs. In contrast, the TANF block grant eliminated the federal entitlement to aid. The federal government provides a fixed amount of funds regardless of

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any changes in state spending or the number of people the programs serve. While the states must also provide a fixed level of funds from their own resources—their maintenance of effort (MOE)<sup>2</sup>—they are now responsible for meeting most of the costs associated with any increase in caseload on their own. How they plan to manage this fiscal risk is what I refer to in this testimony as contingency planning.

In this new welfare partnership, it is tempting to suggest that since welfare reform devolved decisions regarding eligibility and program services to the states, the potential volatility of the caseload is no longer a federal concern. However, in light of both federal requirements and their own fiscal limitations, states will be challenged during a downturn to maintain or increase state funds for benefits when they are most needed. States' decisions regarding who to serve, for how long, and with what services will surely depend on how much flexibility they have with the resources—state and federal—that are available to finance their welfare programs. Although considerable uncertainties exist about the impacts of downturns, the potential cyclical nature of program costs as well as the fiscal constraints states face in responding to hard times heightens the importance of fiscal planning. Helping states maintain their programs was indeed recognized as a federal interest by Congress when it included the Contingency Fund and Loan Fund—mechanisms for states to gain access to additional federal funds—in TANF.

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### Impact of Economic Cycles on TANF Caseloads Is Uncertain

It is unclear what impact a major economic downturn or recession will have on welfare participation given the significant reforms in national welfare policy. Recent studies have tried to establish a link between caseload trends and certain macroeconomic indicators in part to determine how sensitive welfare programs might be to changes in the economy. While the research literature generally suggests that caseloads may very well increase in an economic downturn, there is substantial uncertainty regarding the extent of the impact. These studies point to the variety of other factors affecting caseload levels, particularly with the advent of welfare reform.

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<sup>2</sup>States' MOE requirements are based on their own spending in federal fiscal year 1994 on AFDC, Job Opportunities and Basic Skills (JOBS), Emergency Assistance (EA), related administrative costs, and AFDC/JOBS child care programs: AFDC-Child Care Program, Transitional Child Care, and At-Risk Child Care programs. A state that does not meet PRWORA's work participation rates must maintain at least 80 percent of its MOE. A state that meets its work participation rate must maintain at least 75 percent of its MOE.

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For example, a 1999 Council of Economic Advisors (CEA) report suggests that a 1 percent increase in the unemployment rate could produce a 5 to 7 percent increase in welfare caseloads. However, this same study noted that changes in family structure and welfare policies can significantly mitigate the impact of an economic downturn on caseloads. In fact, the recent caseload drop was at least partly due to reforms ushered in by TANF—the study suggests that about one-third of the caseload reduction from 1996 through 1998—independent of the strong economy.<sup>3</sup>

Just as the reforms may have prompted reduced caseloads during times of economic expansion, greater emphases on work implies a tighter link to work and hence the economy, making TANF more sensitive to an economic downturn than AFDC. On the other hand, the reforms may pose significant disincentives for people to return to the welfare rolls or to apply even if they are eligible during downturns. For example, PRWORA imposes a 5-year lifetime limit on federal assistance on individuals receiving on going assistance;<sup>4</sup> many may try other options first before returning to the welfare rolls. In addition, many states now offer a variety of work supports such as child care, transportation subsidies, and an earned income tax credit (EITC) to families not receiving cash assistance. These supports may be enough to allow earnings from even a part-time job to support a family without returning to the cash assistance rolls.

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## State Budget Processes Could Have an Impact on TANF Programs

Budgetary stress caused by caseload volatility may be compounded by the limitations placed on most states by constitutional or statutory requirements to balance their general fund budgets. During a fiscal crisis, state policymakers face difficult choices regarding whom to serve, for how

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<sup>3</sup>A recent survey of the research literature on this topic notes that there is a “mixed bag” of evidence regarding policy reform’s influence on caseload size. Some studies found that policy reforms did not independently cause—or have an influence—on caseload declines. See Bell, Stephen H. “Why Are Welfare Caseloads Falling?” Urban Institute, March 2001.

<sup>4</sup>In promulgating regulations concerning TANF, the Department of Health and Human Services (HHS) makes a distinction between TANF- or MOE-funded activities that are considered assistance and TANF- or MOE-funded activities that are not considered assistance. The distinction is important because activities that are considered “assistance” are subject to a variety of spending limitation and requirements—including work, time limits, child support assignments, and data reporting. Activities considered to be nonassistance would not have the same requirements associated with them. Assistance includes benefits directed at basic needs even when based on participation in a work experience or community service activity. It also includes childcare, transportation, and supports for families that are *not* employed.

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long, and with what services. But more important to the discussion today is that each of these “hard choices” must be financed in the context of fiscal limitations—including legislative restrictions, constitutional balanced budget mandates, or conditions imposed by the bond market—on state’s ability to increase spending, especially in times of fiscal stress. For example, revenues may come in lower than expected during an economic downturn and a state’s enacted budget can fall into deficit. State balanced budget requirements often motivate states to both reallocate resources within their budgets and cut program spending or increase taxes during recessions. Such difficulties, I am sure, come as no surprise to many of the members of this Subcommittee who have had to make many of these difficult choices while serving in state legislative bodies. For these reasons prudent fiscal planning, especially contingency budgeting for a fiscal “rainy day,” becomes particularly important.

In a fiscal crisis, a state’s need to cut spending or increase revenues can be alleviated if it has accumulated surplus balances in rainy day funds—these surpluses may be used to cover a given year’s deficit.<sup>5</sup> However, unless there are reserves specifically earmarked for low-income families, welfare programs will have to compete with other state priorities for any of the rainy day funds.

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## Reserves Are Key to States’ Contingency Plans But States Cite Disincentives to Save

Finding the right balance between saving and investing resources in programs that help people make the transition from welfare to work continues to be one of the main challenges for states as they develop strategies to address the needs of low-income families. To set aside reserves for future welfare costs, states have two options: they can save federal TANF funds and/or they can save their own funds. However, states noted significant disincentives to save associated with both of these options. State officials told us that there is concern that accumulating unspent TANF balances might signal that the funds are not needed and that they have been under considerable pressure to spend their TANF balances more quickly to avoid the accumulation of large unspent balances in the U.S. Treasury. States have accumulated a portion of their own funds in general purpose rainy day funds, but welfare would have to compete with other claims for these dollars when these dollars are released from state treasuries.

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<sup>5</sup> *Budgeting for Emergencies: State Practices and Federal Implications* (GAO/AIMD-99-250, September 30, 1999).



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## Flexibility of TANF Grants Allows States to Build Reserves

Under TANF, the amount of each state's block grant was based on the amount of federal AFDC funds spent by the state when caseloads and spending were at historic highs. Because caseloads have fallen so dramatically, generally states have been able to reap the fiscal benefits of welfare reform by parlaying abundant federal resources into new programs and savings. Any federal funds they choose to reserve must remain at the U.S. Treasury until the states need them for low-income families.<sup>6</sup> As of September 30, 2000 states reported leaving \$9 billion in unspent TANF funds at the U.S. Treasury; this amounts to 14.5 percent of the total TANF funds awarded since 1996.<sup>7</sup>

Although many might view these balances as a de facto rainy day fund for future welfare costs, in fact there is probably less here than meets the eye. First, as we will discuss in more detail, the data reported by the states is misleading. Second, the reported balances themselves vary greatly among the states, suggesting that some states may not be as prepared to address the fiscal effects an economic downturn may have on their welfare programs without additional federal assistance while others may have saved substantially more than they might need. For example, some states report spending all their federal funds—essentially holding nothing in reserve—while others report accumulated reserves totaling more than their annual block grants. For example, Wyoming reports that nearly 70 percent of the TANF funds it has been awarded since 1997 remain unspent whereas Connecticut reports spending all of its TANF funds.

## Reliable Data on Adequacy of State Reserves Are Not Available

States do not report unspent balances in a consistent manner making it difficult to ascertain how much of these balances is truly uncommitted and available for future contingencies. Therefore, federal policymakers lack reliable information to help assess states' plans for economic contingencies, whether the levels of available funds are adequate, and whether all states have access to these funds.

Department of Health and Human Services' (HHS) regulations require that if a state has allocated a portion of its TANF grant to a rainy day fund, the

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<sup>6</sup>HHS regulations stipulate that a state must obligate by September 30 of the current fiscal year any funds for Expenditures on Non-Assistance. The state must liquidate these obligations by September 30 of the immediately succeeding federal fiscal year for which the funds were awarded. Unobligated funds from previous fiscal years may only be expended on "assistance" and the administrative costs related to providing "assistance".

<sup>7</sup>These data are based on preliminary analysis of state-reported data. As of April 2001, HHS' Administration for Children and Families (ACF) has not publicly released this data.

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state should report these balances as *unobligated*.<sup>8</sup> But, state rainy day funds for welfare programs represent only a portion of the total reported unobligated balances. These balances can represent funds the state has saved for a rainy day, funds for which the state has made no spending plans, or funds the state has committed for activities in future years. For example, in developing a budget for a new child care program, officials in Wisconsin assumed that once the program was fully subscribed it would require all available resources—including any *unobligated* TANF funds from previous fiscal years. State officials said that even though at the end of federal fiscal year 2000 the state reported \$40 million TANF funds as *unobligated*, the state has programmed these funds to pay child care subsidies to low-income families in future reporting periods. This is a case where a reported *unobligated* balance provides very little information about whether these funds are committed or simply unbudgeted.

States also report unspent TANF funds as *unliquidated obligations*, which means that, to varying degrees, an underlying commitment exists for the funds either through a contract for services for eligible clients or to a county for expenses it will incur in operating a county-administered welfare program. But it is unclear how much of what is currently obligated is committed for future needs. For example, both California and Colorado have county-administered welfare systems. These states pass most of their annual block grant directly to the counties. As caseloads have continued to decline in both states, the budgets over-estimated expenditures leaving considerable balances unspent. Although these funds remain in the U.S. Treasury until a county needs to spend them, they remain as *unliquidated obligations* committed to the counties. California reports that it has over \$1.6 billion in unliquidated TANF obligations. But the state reports no *unobligated balances*, implying that all these funds are earmarked. Recently, California amended its state statute to allow the state to deobligate some of these funds, if necessary, and make them available to other counties. Likewise, as of September 30, 2000 Colorado reports about \$95 million in *unliquidated obligations*, but passes virtually all TANF resources to the counties. As of June 30, 2000 the state estimated that counties hold about \$67 million in reserves—or about 70 percent of the total *unliquidated obligations*—for future contingencies.

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<sup>8</sup> HHS regulations require states to report on the status of their unspent TANF funds. Under HHS regulations the states use two categories to report on the status of these funds: (1) *unobligated balances* represent funds not yet committed for a specific expenditure by a state and (2) *unliquidated obligations* represent funds states have committed but not yet spent.

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As highlighted in the above examples, the difference between *unobligated balances* and unliquidated obligations is often unclear and varies by state. Significant portions of California's and Colorado's unspent funds are not yet actually committed for specific expenditures but these facts cannot be determined based on the aggregate data, in part because of the way HHS requires states to report funds. Reporting a significant share of their unspent balances as *unliquidated obligations* implies that there is an underlying commitment on these funds when, in fact, these funds are no more committed than the funds Wisconsin must report in its *unobligated balances* but which are budgeted for expected outlays in Wisconsin's child care subsidy program.

Contingency Planning Receives Little Attention as States Cite Few Incentives to Save

Even though some states might consider their *unobligated balances* for TANF to be rainy day funds, it does not appear that the amounts reserved were based on any kind of contingency planning or analysis. For example, 5 of the 10 states we studied told us that they consider a portion of the funds left at the U.S. Treasury to be rainy day funds for unanticipated program needs. But the levels of the reserves established in those five states were not determined through a fiscal planning process that reflects budgetary assumptions about projected future needs. Instead, these states' statutes merely designate all TANF funds not already appropriated by the state legislature for other purposes as constituting the state's welfare rainy day fund, a method that clearly is not based on anticipated needs or contingencies.

Improved Reporting Requirements Could Improve Federal Oversight and Provide States With Incentives to Save

The lack of transparency regarding states' plans for their unspent TANF funds prompted us, in 1998, to recommend that HHS and the states work together to explore options for enhancing the information available regarding these balances. Although HHS, the National Governor's Association (NGA), and the National Conference of State Legislatures (NCSL) all agreed with us that more information regarding unspent TANF balances would be useful, little progress has been made implementing this recommendation and HHS' final regulations, issued on April 12, 1999 did not address this issue. States were already concerned that the TANF reporting requirements would pose a substantial burden on state program administration and argued that adding another reporting requirement to allow states to signal their intentions for their unspent balances would only add to those burdens. However, the lack of useful information on these balances continues to weaken the effectiveness of congressional oversight over TANF funding issues, including how well prepared states may be to address a fiscal downturn.

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Our 1998 recommendation proposed a strategy that state and federal officials had tried before and found to be successful. In 1981, a number of categorical grants were block granted to states to provide maximum flexibility in developing and managing programs, along the same lines that TANF was designed in 1996. However, due to variations in the way states reported information to the federal government on activities funded by some of these block grants, Congress had no national picture of the grants' impact. States and some national organizations recognized that these aggregate data were important and developed their own strategies to collect the data.<sup>9</sup> We found that a cooperative data collection approach was easier to implement when (1) there was federal funding to support data collection activities, (2) national-level staff worked with state officials, and (3) state officials helped in systems design. We continue to believe that better information on the status of these unspent balances is crucial to effective oversight and could even enhance states' incentives to save some of their TANF funds. Absent credible information on balances, there may be a greater risk that Congress could take action to recoup TANF funds—a prospect that has prompted some states to draw down and spend their TANF funds rather than leave them in the Treasury.

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### States Have Few Incentives to Create State-Funded Welfare Reserves

Although many states have healthy general rainy day funds from which all programs would compete for funds during times of fiscal stress, only one of the states in our review, Maryland, has earmarked state funds in a reserve specifically for contingencies in its welfare program. Setting aside state funds in reserve for welfare requires tradeoffs for state decisionmakers among competing needs for the funds during a downturn. In addition, any funds a state sets aside for future welfare contingencies cannot count toward a states' maintenance of effort in the year they are reserved—in order to qualify as MOE, the funds must be spent. Therefore, it is a very expensive proposition indeed for a state to budget both for a welfare reserve and to meet its MOE because it then would have far fewer resources available to finance other state priorities.

Maryland found a way to transfer the costs of saving state funds to the federal government. In state fiscal year 2001, the state identified nine program accounts with annual expenditures of state funds totaling about

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<sup>9</sup> *Block Grants: Federal-State Cooperation in Developing National Data Collection Strategies* (GAO/HRD-89-2, November 29, 1998) and *Block Grants: Federal Data Collection Provisions* (GAO/HRD-87-59FS, February 24, 1987).

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\$30 million that, under the broad and flexible rules governing TANF expenditures, could be funded with federal funds. In developing the budget, the state replaced these state funds with federal funds. Instead of using the “freed-up” state funds for nonwelfare activities the state used them to establish a dedicated reserve for its welfare program.

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## Design of Federal Contingency Mechanisms Is Complex and Restrictive

While the ability to carry forward TANF balances is likely viewed as the principle mechanism by which states can prepare for a rainy day, PRWORA also created two safety-net mechanisms for states to access additional federal resources in the event of a recession or other emergency—the \$2 billion Contingency Fund for State Welfare Programs (Contingency Fund) and the \$1.7 billion Federal Loan Fund for State Welfare Programs (Loan Fund).

The Contingency Fund is authorized through 2001, at which time it expires. The President’s fiscal year 2002 budget proposal did not include a request to reauthorize the Contingency Fund. Because of a provision in the Adoption and Safe Families Act of 1997 that reduced the TANF Contingency Fund by \$40 million, the current balance in the Contingency Fund is \$1.96 billion.<sup>10</sup> States are deemed “needy” and eligible to receive funds from the Contingency Fund if they trigger one of two criteria: (1) the state’s unemployment rate exceeds 6.5 percent for 3 months and is equal to at least 110 percent of its rate in the same period of the previous year or (2) its average monthly food stamp caseload for the most recent 3-month period is equal to at least 110 percent of the average monthly caseload from the same 3-month period in fiscal year 1994 or 1995. Once eligible, a state must certify that it has increased its own current spending to prewelfare reform levels before it can gain access to the fund.

Requiring states to increase their own financial stake in their welfare programs before giving them additional federal funds is, in principle, a reasonable approach that seeks to balance both the federal government’s interest in ensuring that states in trouble have access to additional funds and its interest in ensuring that states have done everything possible to address the shortfalls before turning to the federal treasury. Not only does the statute require states to bring their spending up to the prewelfare reform levels at a time when states are experiencing fiscal stress, but

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<sup>10</sup>The Adoption and Safe Families Act of 1997 reduced the contingency fund for state welfare programs by \$40 million over four years (P.L. No. 105-89, §404, 111 Stat. 2134)

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PRWORA establishes a different and more challenging base for the Contingency Fund's MOE. While a state's MOE requirement under the basic TANF program can include state funds expended under certain state programs and child care expenditures, the MOE requirement for the Contingency Fund does not include these items.

Because states spend a significant share of their MOE funds on activities that do not qualify as Contingency Fund MOE expenditures, state budget officials told us that, rather than shifting their spending priorities to meet the Contingency Fund MOE, they would find other ways to manage deficits in their TANF budgets before they could consider turning to the Contingency Fund. In 1997 eight states qualified for contingency funds.<sup>11</sup> However, only two states requested and were awarded contingency funds—North Carolina and New Mexico. In the end, only New Mexico complied with the Fund's requirements and accepted \$2 million. No state has used the Fund since 1997.

Equally important as the requirement that states raise their own financial commitment in order to gain access to additional federal funds is a requirement that states share in all additional program costs—even beyond the MOE requirements. Requiring a match encourages states to be more cost-conscious than if the costs of an expanding caseload were covered only with federal dollars. While the Contingency Fund requires states to match all federal dollars at the states' federal medical assistance percentage (FMAP) rate<sup>12</sup> the statute goes a step further. The statute limits the monthly draws to one-twelfth of 20 percent of a state's annual block grant. This limitation requires a complex annual reconciliation process to certify that the state meets its matching requirement but also that it did not receive more than its monthly proportional share of contingency funds (see figure 1).<sup>13</sup> Prorating a state's draws from the Contingency Fund—especially if the state qualifies for a period that spans two federal fiscal years—reduces the share of federal funds to which it is entitled. This effectively increases the matching requirement (even higher than required under AFDC), thus raising the state's costs for gaining access to the funds.

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<sup>11</sup>These states are Alaska, California, District of Columbia, Hawaii, New Mexico, New York, North Carolina, and Washington.

<sup>12</sup>Under AFDC, state spending was matched at a rate based on each state's per capita income. This rate, FMAP, is also used for other federal-state matching programs such as Medicaid. It ranges from 50 percent for wealthy states to 80 percent for poorer states.

<sup>13</sup>For more information see [GAO/AIMD-98-137](#).

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**Figure 1: The Contingency Fund’s Annual Reconciliation Process**

As currently structured, the reconciliation process favors states that are “needy” within a single federal fiscal year compared with those that are “needy” in months that overlap consecutive federal fiscal years. A state that is needy for all 12 months during a federal fiscal year would have to match all funds drawn at its applicable fiscal year FMAP rate with no adjustments for the number of months it was eligible because it was needy throughout the year. However, a state that is needy for 12 consecutive months that span 2 federal fiscal years (e.g., 6 months in each year) with an identical FMAP rate will see its federal match rate reduced by half because of the adjustment made for number of months the state was needy in each year.

To illustrate, the state that was needy for an entire federal fiscal year and was eligible for and had drawn \$20 million of contingency funds would be able to retain these funds, provided the state had spent the necessary matching funds. In contrast, the state that qualified as needy for the same number of months and was eligible for the same amount from the contingency Fund but overlapping 2 fiscal years would initially obtain \$10 million in each year, reflecting its 6 months of eligibility in each year, but then the state would have to remit half of these funds after each year’s reconciliation. This latter reduction is the result of prorating the state’s grant by the number of months it was eligible for contingency funds, even though the state’s initial claim for each year was already based on the number of months of eligibility. As a result, the second state would be allowed to retain a total of \$5 million of federal funds in that fiscal year, \$5 million of federal funds in the next fiscal year—a total of \$10 million even though its eligibility over these 2 years was the same as the state receiving \$20 million. In addition, the second state would have to meet the Contingency Fund MOE in both years.

Unlike the Contingency Fund, the Loan Fund does not have triggers. Instead, states that have not incurred penalties for improper use of TANF funds are eligible for loans from the Loan Fund. Such loans are to have a maturity of no more than 3 years at an interest rate comparable to the current average market yield on outstanding marketable obligations of the U.S. Treasury with comparable maturities. Some state officials told us that they are eligible for better financing terms in the tax-exempt municipal bond market. More important, officials in some states indicated that borrowing specifically for social welfare programs in times of fiscal stress would not receive popular support.

In summary, neither the Contingency Fund—as currently designed—nor the Loan Fund is likely to be used by states in a fiscal crisis to obtain more resources for their welfare programs. The Loan Fund is most likely the wrong mechanism to provide assistance to states in a fiscal crisis. However, if the Contingency Fund is reauthorized, Congress could also contemplate improvements to enhance its usefulness in addressing budgetary shortfalls in states’ welfare programs that, at the same time, could provide stronger incentives for states to save for a rainy day.

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## Options to Strengthen Contingency Planning

Although PRWORA struck a new fiscal balance between the federal government and the states in terms of welfare spending, both the states and the federal government have a significant interest in preparing the program to meet challenges in times of fiscal distress. Contingency planning is about being prepared for the unknown—as the economy shows possible signs of weakening, we need to begin to think about how prepared we are to maintain this important aspect of the nation’s safety net. Although many view the states’ large unspent TANF balances as the de facto contingency fund, these balances vary across states; this implies that some states may be better prepared for a recession than others. More important, current reporting requirements do not give us reliable, consistent information regarding states’ actual plans for these monies. According to NGA, few states have engaged in a systematic fiscal planning process to project their needs under a variety of economic scenarios. While we don’t know how states’ welfare programs will respond to a weakened economy, we know both the federal government and the states have a responsibility to ensure the viability of TANF in good times and bad.

Before addressing how contingency planning can be improved for the future, the federal government needs better information on states’ current plans. At the same time, Congress could consider ways to both strengthen federal contingency mechanisms and give states greater incentives to save for the future.

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## Improved National Reporting

In 1998, we recommended that the Secretary of Health and Human Services explore with the states various options to enhance information regarding states’ plans for their unused TANF balances. We said that such information could

- include explicit state plans for setting aside TANF-funded reserves for the future,
- provide more transparency regarding these funds and enhance congressional oversight, and
- provide states with an opportunity to more explicitly consider their long-term fiscal plans for TANF.

Although HHS concurred with our recommendation, to date, we have seen no progress in this area. We continue to believe that Congress would benefit from more complete information on states’ plans for future contingencies, including unspent TANF balances. While states often face burdens with respect to federal financial reporting requirements, states



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have historically recognized the benefits of cooperative data collection and reporting efforts and worked successfully with federal agencies to collect data that can give oversight officials a broad, national perspective of how they are using federal block grant funds. Allowing for more transparency regarding states' fiscal plans for TANF funds could enhance congressional oversight over the multi-year timeframe of the grant and provide states with an opportunity to more explicitly consider their long-term fiscal plans for the program. While the opportunity to more clearly signal their intentions for these funds could prompt states to save, Congress must have some assurance that states' estimates of their contingency needs were developed using credible, realistic estimating procedures.

In order for a state to report to the federal government a balance in a rainy day fund, and in order for the federal government to have some level of confidence in such a figure, the federal government could give states guidance on how it could designate its TANF balances as a valid rainy day fund. Such guidance could include requirements that a state rainy day fund (1) include criteria both for estimating the appropriate reserve balances and for releasing funds and (2) be auditable. This guidance could help states signal that much of these balances are, in fact, committed. Furthermore, requiring that reserves be determined by credible, transparent estimating procedures would help provide better estimates of the potential need for federal contingency funds.

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## Options to Improve the Federal Contingency Mechanism

The Contingency Fund, as currently designed, has not proven to be an inviting option to the states that have actually experienced fiscal stress to date. Should Congress decide to reauthorize the Contingency Fund, consideration could be given to approaches that could both improve the usefulness of the fund for hard-pressed states as well as ensure that states contribute their fair share to future welfare costs. Such approaches could include (1) eliminating the more restrictive the Contingency Fund-MOE and substituting the more flexible basic TANF-MOE and (2) eliminating the Monthly Payment Limitation (MPL) on the amount of contingency funds to which each state has access. These actions could help strengthen the role of the Contingency Fund in state contingency budgeting.

Realigning the MOE and eliminating the MPL would make the Contingency Fund more accessible and, therefore, more responsive. If states had better access to federal contingency funds, they might be more likely to use the money when needed. However, greater accessibility must be balanced by fiscal responsibility. It is important to be mindful of this balance so as not

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to make it too easy for states to access federal contingency funds because they might be less likely to save for a rainy day on their own, which could pose risks to the federal Treasury.

The changes discussed above would still require states to increase their own spending to pre-TANF levels (i.e., meet a 100 percent MOE) to gain access to the Contingency Fund—a higher level than they must maintain for the regular TANF program—as well as provide a matching share for the additional federal funds. By broadening the fiscal base that states can draw upon to meet this higher MOE, these changes might not only make the fund more accessible in times of need but prompt states to save their own funds in anticipation of accessing the federal funds.

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## Options to Increase States' Incentives to Save

There are other options that could strengthen states' incentives to save. For example, Congress could (1) allow states to count rainy day funds towards their MOE and (2) allow states to draw down their entire TANF grant and save these funds in their own treasuries.

Allowing states to count rainy day funds towards their MOE would give them a greater incentive to save. However, "maintenance of effort" implies an actual expenditure, and is a critical aspect of PRWORA. If states save their own funds instead of spending them, they might be more likely to draw down all of their TANF dollars now to replace the state dollars they save for the future. However, this outcome can be mitigated by limiting the amount of rainy day funds that states could count towards their MOE. In addition, as we suggested earlier when discussing the TANF balances saved by states, states could also be required to certify that state rainy day funds are in fact auditable and include criteria for estimating and releasing the funds.

Some state officials have argued that their incentive to save TANF funds for the future could be bolstered by allowing states to keep unspent TANF funds in their own accounts rather than at the U.S. Treasury. They believe that this might reduce incentives for Congress to rescind unspent balances since the outlays would be recognized earlier at the time of the grant award, not when the money is actually spent for a program need. State officials also told us that this would alleviate the perceived pressure to spend TANF funds rather than save them. However, it is important to note that, regardless of where these federal funds are "stored," states are accountable for these funds. As such, Congress still needs consistent, reliable, and auditable information on these funds.

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There are significant issues associated with this proposal. First, if states draw down all unspent balances in the current year, the rate of outlays recorded for the TANF program would shift forward. Accordingly, the federal budget surplus would be proportionately lower in the near term. Second, the federal government would incur interest costs while states could realize interest earnings. The Cash Management Improvement Act of 1990 (CMIA) helps ensure that neither the states nor the federal government incur unnecessary interest costs or forgo interest income in the course of federal grant disbursement by prohibiting states from drawing down funds until they are needed. If Congress permitted, notwithstanding CMIA, states to draw down their TANF balances to establish reserves, it could also require states to reimburse the U.S. Treasury for any interest they earn on the drawdowns. This would maintain the spirit of the CMIA by preserving fiscal neutrality for the federal government and the states, since the states could use interest earnings they gain on investing the drawdowns to reimburse the Treasury.

Essentially, states would have to justify why TANF deserves an exemption from a governmentwide grant policy that settled years of intergovernmental conflicts between federal and state administrators. The permanent nature of the appropriation to each state as well as the significant devolution of responsibilities to states for addressing the program's fiscal risks may argue for such a change, but other federal interests would have to be weighed as well. For example, some may argue that CMIA promotes transparency by ensuring that states' unspent balances remain in the federal Treasury rather than in state treasuries. This concern could be addressed through federal reporting on states' expenditures and reserves.

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In conclusion, the TANF program has established a new fiscal partnership that has supported the transition to work-based welfare reforms. Because the partnership has yet to be tested in times of fiscal stress, now is the time for both federal and state governments to consider actions to prepare for more uncertain times and the possibility of higher program costs. Although TANF currently contains certain mechanisms to provide a fiscal cushion, the options we have presented provide an opportunity to promote greater assurance that all states will be poised to respond to future fiscal contingencies affecting their TANF programs.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

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## Contacts and Acknowledgements

For future questions regarding this testimony please call Paul L. Posner at (202) 512-9573. Individuals making key contributions to this testimony included Thomas M. James, Bill J. Keller, Jacqueline M. Nowicki, Patricia L. Elston, Gale Harris, and Raymond G. Hendren.